Summary

The Impact of Rent Review on Rental Housing in Ontario: A Staff Research Report

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This publication was prepared by the staff of the Ministry of Municipal Affairs and Housing with the assistance of consultants. As a staff research report, it represents the technical analysis of staff alone and does not indicate policy direction.

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This report is based on computer simulations, surveys and statistical analysis, in addition to extensive searches of the existing literature. As such, it represents an extremely complicated research project that attempts to integrate many contributions into a coherent whole. Because of this, the final product inevitably contains interpretations that will not represent the views of all involved in the report. Nevertheless, it is also true that everyone made significant contributions to the overall effort and it would have been impossible to prepare this document without their assistance.

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Patrick T. Laverty, Project Manager

Introduction

In the six years since the establishment of rent review in Ontario, there has been a good deal of public interest in the implications of the legislation on tenants, landlords and others. This report examines evidence related to some of the important issues.

The questions addressed are:

- What impact has rent review had on rents and on the supply and demand for rental housing?
- To what extent are maintenance levels of rental buildings regarded as inadequate or deteriorating?
- How have rates of return fared under rent review and what impact has this had on landlords' behaviour?
- Have there been other direct and indirect effects of rent review that have had important consequences?
- How well does rent review perform as a means of assisting tenants with housing affordability problems?
- To what extent are the redistributive effects of rent review shared equitably among landlords and tenants?
- How does rent review relate to tenant security of tenure and to the property rights of landlords?
- How do rent review policies relate to basic economic values and perceptions?

In examining these issues one is continually confronted with the necessity of making choices between problems. Each of the problems raised can be solved individually, but only at the cost of accepting some other problem. This fact is by no means unique to the issue of rent review. It is true of most social and economic policy issues. In the final analysis, one must choose the problems one wishes to have.

A Brief History

In December of 1975, the Legislature of Ontario passed The Residential Premises Rent Review Act. This Act limited rent increases on buildings rented prior to 1976 to 8 per cent unless the landlord received approval from a Rent Review Officer for a different increase. Decisions of the Rent Review Officer were to be based, in large part, on increases in costs, although provisions were also made for elimination of financial loss and for rent reductions in cases where services had been eliminated.

The original legislation was scheduled to terminate in August of 1977. In that year, however, the legislation was extended. The rate of allowable rent increase was reduced to 6 per cent in the fall of that year.

In 1979, The Residential Premises Rent Review Act was replaced by sections proclaimed from The Residential Tenancies Act. The new Act retained the 6 per cent increase and the cost based criteria for landlord applications. For the first time, a relief of hardship provision was included that permitted the Residential Tenancy Commission to make an award of additional revenue to the landlord equal to a maximum of 2 per cent above costs. The new legislation also changed the basis for tenant applications from a cost based system to one based on the rental levels in comparative units. Finally, the new Act did not contain a termination clause.

Supply and Demand (Chapter 2)

In recent years, rental vacancy rates have fallen in many parts of the Province. By October of 1981, 9 of the 10 largest urban areas in Ontario had vacancy rates below 3 per cent. The Toronto vacancy rate was 0.3 per cent. In the Toronto Census Metropolitan Area, rents on uncontrolled units began to climb in 1981.

As vacancy rates decline a major issue will be the relationship between rents in controlled and uncontrolled buildings, in that, the lower the rate of rent increase in the controlled sector, the larger the rent increases in the uncontrolled market will be.

It is important to understand why this inverse relationship will develop between controlled and uncontrolled rents. Until quite recently, vacancy rates throughout the Province have been high enough to ensure that enough competition existed so that uncontrolled rents stayed roughly in line with controlled rent increases. In some areas, most notably Toronto, vacancy rates have now fallen to levels where competition no longer serves as a fully effective limit on uncontrolled rent increases.

With controlled rents limited to below the rates of price and wage increases, controlled units have become underpriced with a resulting stimulation of demand. In large part this additional demand has been by non-family household units: young people leaving home or those obtaining separate units instead of sharing accommodation with friends. In contrast to the increased demand, the supply of controlled units in some areas may be decreasing, either because of the natural aging process of the units or because of the increasing value of the units for other uses, including homeownership.

The combination of increased demand and diminished supply of controlled units produces a spillover of demand into the uncontrolled sector and this increased demand results in the upward pressure on the rents of these uncontrolled units.

The implications of this analysis have been explored for both Toronto (a low vacancy rate area) and London (a higher vacancy rate area). Scenarios have been developed using a number of assumptions about background economic conditions and other rental policies.[1] These assumptions have been held constant, however, in order to isolate the impact of rent review on future developments.

Table 1.1 presents the outlook in the Toronto area for both controlled and uncontrolled rents. The most noticeable feature is the strong run up of uncontrolled rents in the 1982 to 1984 period. In part, this is due to the starting point of low vacancy rates combined with subsequent increases in demand associated with demographic and economic forces and the inadequate volume of new supply. It is also apparent, however, that the extent of uncontrolled rent increases is strongly related to the rate of controlled increases. Higher guideline rates produce lower increases in the uncontrolled sector.

Table 1.1

Average Annual Increase in Real Rent
(Rent Increase in Relation to Inflation)
Alternative Scenarios for Toronto

Guideline Policy	Controlled Rent		Uncontrolled Rent	
From 1982 on	1982-84	1984-86	1982-84	1984-86
	(Per Cent Change)			
4% Guideline	-8.3	-6.5	+23.8	-0.7
6% Guideline	-5.1	-3.2	+20.6	-2.2
9% Guideline	-0.6	+0.8	+16.3	-3.1
Inflation Rate Guideline	+1.5	+0.3	+14.7	-3.4
Decontrol	+14.4	+2.3	+5.1	-4.3

Source: Computer simulation performed by Econalysis Consulting Services.

[1]Major economic assumptions: deceleration of inflation to about 8 per cent in 1985-1986; reduction in interest rates by stages to 12 per cent in 1986; moderate growth in incomes relative to inflation; and a continued gradual decline in demographically based demand. Major policy assumptions: continuation of Ontario Rental Construction Loan and a tax write-off similar to the Multiple Unit Residential Building tax write-offs or the introduction of new assistance of equivalent value.

The 1984 to 1986 period shows a much different pattern. In part this is due to the fact that increasing rents in the uncontrolled sector attract additional supply either through the building of new units or the transfer of units from ownership to uncontrolled rental use. The belief that these units will not subsequently be controlled is crucial to this supply effect. Another effect of the rise in the real rent level for the uncontrolled sector in the period 1982 to 1984 is a reduction in rental demand. A major consequence of these two market trends of increased supply and reduced demand is a higher vacancy rate in the uncontrolled sector by 1986. The other factor at work relates to the increase in controlled rents. The higher the controlled rent increase, the lower the increase in uncontrolled rents relative to inflation. This is because increased controlled rents serve to reduce demand, thereby reducing demand spillover into the uncontrolled sector, and also reduce the rate of transfer of units from controlled to ownership use.

The situation in London differs greatly from Toronto because of the higher level of current vacancies. Table 1.2 presents the information for London on controlled and uncontrolled rent increases. Uncontrolled rents do show a tendency to increase more rapidly the lower the level of controlled rent increase, because of the declining vacancy rate that develops under these conditions.

Table 1.2

Annual Average Increase in Real Rent
Alternative Scenarios for London

Guideline Policy From 1982 on	Controlled Rent 1982-84	Controlled Rent 1984-86	Uncontrolled Rent 1982-84	Uncontrolled Rent 1984-86
	(Per Cent Change)			
4% Guideline	-7.6	-5.8	+6.8	+2.0
6% Guideline	-4.7	-2.9	+4.8	+1.1
9% Guideline	-0.4	+0.7	+2.4	-0.1
Inflation Rate Guideline	+1.4	+0.2	+1.1	-0.2
Decontrol	+2.0	+0.3	+0.6	0.0

Source: Computer simulation performed by Econalysis Consulting Services.

At higher guideline rates the increases in both controlled and uncontrolled sectors are moderate in relation to inflation. Thus, while the same forces are clearly at work in London as in Toronto, the effects on London are much more moderate. Most other cities in Ontario would fall between these two in terms of market reactions.

Maintenance (Chapter 3)

One of the concerns shared jointly by tenants and landlords is the possibility of deterioration in maintenance levels under rent review. The economics of this potential development are straightforward. If landlords are not allowed to maintain their profits in line with increasing inflation by raising rents, then they can be expected to attempt to do so by reducing costs. And maintenance is an area of expenditure that is often regarded as particularly vulnerable to cutbacks in that other reductions are more difficult to make or more immediately visible.

In contrast to the already deteriorating conditions of supply and demand, there is little evidence to date of serious reductions in the observed quality of maintenance conditions. For a number of years the Ministry has conducted a rental market survey which asked tenants, among other things, to rate their perceptions of maintenance. Invariably, the finding was that over one-half of all respondents rated their maintenance as good or very good, while another quarter rated it as adequate. Only 10 to 20 per cent rated it as poor or very poor. Also, two-thirds or more of all tenants indicated that standards had not changed in the past year, with the remaining third split between improving and declining conditions.

The general results of these previous surveys have now been confirmed by a comprehensive set of surveys conducted for the Ministry in Toronto. The set of surveys included not only tenants, as in the previous surveys, but also landlords and independent site visitors. Furthermore, the range of questions probed much more deeply into the observations of maintenance conditions.

Regarding the current state of overall maintenance, some 80 per cent of site visitors and 90 per cent of all landlords indicated that levels of maintenance were good or very good.[2] When tenant views were averaged for each building, some 55 per cent of all buildings were given a rating of good or very good, and almost 40 per cent of all buildings had an average tenant rating of adequate.[3] In these three surveys the number indicating poor maintenance was under 20 per cent and the number of very poor buildings was less than 3 per cent.

The evidence on changes in maintenance is just as clear. In about 90 per cent of all buildings the average tenant response was that maintenance had remained the same over the past year. For the same period of time about two-thirds of all landlords reported no change in standards of janitorial care and repairs, while about one-fifth indicated improvements in the past year.

[2] No "adequate" category was included for either landlords or site visitors.

[3] Some of the difference in tenant views between this maintenance survey and the previous rental market surveys is due to the averaging of responses for buildings.

The survey also indicated that low levels of maintenance tended to be associated with older buildings, low rent buildings, buildings where tenants indicated 24 hour maintenance service was not available, and buildings owners intended to sell. High ratings tended to be associated with the opposite characteristics. Building size was not strongly related to higher than average or substantially below average ratings, although the smallest size surveyed (20-49 units) did tend to have ratings just below average. It should be pointed out that a number of individual buildings had maintenance performances that differed from these generalizations.

The landlord survey also asked the respondent to indicate the obstacles to better maintenance. Almost one-third indicated no obstacles, while over half mentioned either lack of funds or rent review. Age of building or equipment was mentioned by one in eight, while several other responses were indicated by a scattering of owners.[4]

In general, tenants, landlords and site visitors have confirmed that, in terms of results, maintenance levels in Ontario are good or very good and landlords and tenants agree that little change is occurring in these levels. To the extent that maintenance falls short of ideal, landlords attribute this to financial factors, including rent review.

Rate Of Return (Chapter 4)

In considering both the supply of rental units and the maintenance of buildings, profit performance appears to play a role in the process of providing an adequate quantity and quality of rental housing. Thus, it is of importance to tenants, as well as landlords, that adequate returns exist.

Landlords are concerned not only with the expected level of profits, but also with the amount of uncertainty associated with that return. The higher the return and the lower the risk the greater the incentive to provide rental housing.

In this study attention has been given to both the return on total capital, including both landlord and mortgage lender, and the return on equity of the landlord alone. While there are important differences in the interpretation of these measures, the overall results tell a consistent story in this case.

In order to examine the financial returns on rental investment, landlords were surveyed in both Toronto and London. One-third of the landlords approached provided access to financial information. While this response does not permit one to use the results as representative of all landlords, it does provide a detailed look at the financial and management performance of a number of landlords.

[4] A number of landlords mentioned two factors.

The adequacy of returns can be judged in a number of ways. First, actual returns can be compared to a landlord's own definition of adequate return. Second, returns can be compared to the rate of inflation. Third, return on rental buildings can be compared to that available on other investments. Finally, adequacy of return can often be reflected in the management behaviour of landlords. Each of these methods can be used in evaluating the performance of surveyed landlords.

As part of the survey, landlords were requested to indicate the rate of return that they considered adequate on their investment. This amount was compared with the return they actually achieved. For the 59 properties for which comparisons could be made, 34 of them (58 per cent) experienced a return lower than their target rate.

Both the annual return to total capital (including mortgage lender) and to the landlord alone were compared with the rate of inflation. The return to total capital exceeded the rate of inflation in six of the ten years (1971-1980) while the return on landlord equity increased by more than the rate of price increases in only one of the ten years.

Two comparisons with other investments were made. The return on total capital after tax averaged 6.3 per cent for the landlords responding, whereas the return for industry in general was 11.7 per cent. The return on equity before tax was 14.1 per cent for the sample, and 15.4 per cent for stocks on the Toronto Stock Exchange Index of 300 stocks. The return on landlord equity was substantially higher than the return on fixed income bonds during the 1970's, but this relationship is now quite different given current interest rates.

The management behaviour of landlords is particularly important in that it directly affects tenants. As part of the survey, landlords were asked questions that dealt with key management decisions. It became apparent in analyzing the results that many of the landlords saw themselves faced with a decision between adequate profits and quality operation of their building.

In all, seven distinct management strategies were identified. Five of them involved either below average profitability or reductions in quality or both. One group was being forced out of business by large cash flow losses. A second was systematically taking its investment equity out of its building. A third was cutting back on current expenditures in order to retain good levels of profits, while a fourth was maintaining cash flow by deferring capital expenditures. The fifth group was maintaining building quality and increasing equity, but was suffering from below average rates of return.

Of the two other groups, one was distinguished by the fact that it relied heavily on large current cash flows from Multiple Unit Residential Building (MURB) tax write-offs. The remaining group was able to have above average profits and to maintain high quality buildings.

The overall conclusion is that a considerable number of landlords are experiencing some degree of financial pressure and in a number of cases this is affecting the quality of building operation. While the

Maintenance Survey found that results had not yet been seriously affected, it would appear that a number of landlords are cutting back on expenditures. This implies that reductions so far have been limited to either efficiency improvements or to marginal reductions in service. Some question exists, however, as to whether future reductions will be as innocuous in that limits must exist on the potential for such savings. Beyond this point, cost reductions will have an impact on the level of services.

Direct and Indirect Costs (Chapter 5)

The major additional impacts concern the direct and indirect costs to government of rent review and the potential implications of rent review for decline in respect for the legal system.

While the direct cost of rent review was $4.7 million in 1980, the costs to all levels of government were in the order of $100 million in that year. Indirectly, rent review contributed to additional expenditures associated with the federal Assisted Rental Program, and the provincial Ontario Rental Construction Grant. In addition, rent review contributed to a number of reductions in tax yield to all levels of government. At the federal and provincial levels there were reductions associated with the MURB tax write-off, reductions in the income and capital gains taxes from landlords and loss on the provincial capital tax. Municipal property taxes were also lower given the reduction in new rental construction. Thus, the cost to governments and to taxpayers generally, go far beyond the direct program expenditure for rent review and affect all three levels of government.

Respect for the law is fundamental to social order. Laws that give rise to wide abuse, therefore, serve as a challenge to that order. Reports of evasion, key money, black markets and similar practices should be of general public concern. The extent of these practices could not be documented in the study.

Other costs that are difficult to quantify are: the increased search time for rental units by tenants in tight rental markets; the loss by tenants who have to settle for units that are sub-optimal in terms of characteristics or location; and the costs and frictions experienced by both landlords and tenants in the process of compliance with the legislation.

Affordability (Chapter 6)

The impact of rent review on the affordability position of tenants is an important issue in the consideration of the performance of the program. Of relevance to such an evaluation is the number of those helped and the efficiency of rent review in providing assistance.

The number of people with affordability problems depends on the definition of what constitutes a problem household. In 1978, the

percentage of unsubsidized renter households paying over 25 per cent of their income on rent was 30.2 per cent, while 23.2 per cent paid over 30 per cent of income on rent. The sensitivity of these estimates to changes in rents can be seen in Table 1.3. As can be seen, a 10 per cent change in rents relative to income changes the per cent of those with a problem by 3 to 4 percentage points. In that wages and other incomes have been increasing at more than average rent increases since 1978, the number with affordability problems is probably declining.

Table 1.3

Sensitivity of Affordability Measures to Changes in Rents Relative to Income 1978

Per Cent Change in Rents Relative to Income	Per Cent of Households with Problem	
	25% Threshold	30% Threshold
10% higher	35.9	27.1
5% higher	33.2	25.3
no change	30.2	23.3
5% lower	28.4	21.9
10% lower	26.4	20.4

Source: J. Miron "The Affordability of Rental Housing in Ontario: Empirical Findings," (Ministry of Municipal Affairs and Housing, 1981) based on unpublished data from Statistics Canada Household Income, Facilities and Equipment, 1978.

While rent review has played a role in reducing the number of those who have affordability problems, there certainly may be some questions as to the efficiency of the program. It should be obvious that if 23 to 30 per cent of private market tenants had an affordability problem in 1978, then 70 per cent or more of tenants did not have a problem. Indeed, only about one dollar in four of rent reduction went to those with the worst affordability problem, i.e., those spending over 30 per cent of their income on rent. When other costs of rent review borne by government ($100 million) are combined with the costs to landlords of rent reductions ($160 million) about one dollar in seven ($39 million) was transferred to those with an affordability problem. Clearly, these transfer efficiency rates are well below those that would be attainable from alternative measures more specifically targeted at those with affordability problems.

Redistribution (Chapter 7)

The fairness of the rent review policy is partly dependent on the allocation of impacts of rent reduction and the corresponding loss of income.

One way of viewing these impacts is in terms of the allocation of benefits and costs among income groups. Rent review does accomplish some degree of redistribution from higher to lower income groups. About one-third to two-fifths of households with low and moderate incomes benefit from rent review, while a smaller percentage of higher income people derive benefits. Also, about three-quarters of the cost in terms of rent reduction are borne by the top 60 per cent of the income distribution.

While the net distribution goes from rich to poor, rent review is far from perfect as a method of redistributing income. Over one-half of the total benefits go to the top 60 per cent of households by income. Renters in the highest income groups receive average rent savings that are 40 per cent more than those in the lowest income group. The cost in reducing income is borne by only a small proportion of the population implying substantial costs to landlords, while others of the same income level bear no direct costs. And, as indicated above in the section on Supply and Demand, there is a growing inequity between tenants and landlords in the controlled and uncontrolled markets.

Redistribution can also be looked at by age and family type. A clear finding is that rent review redistributes income from those over 40 to those who are younger, with the largest net losses being borne by those 65 and over and the largest net gains going to those under 25. While rent review undoubtedly benefits many older tenants, their gains are less than the financial loss experienced by the elderly with rental investments.

In so far as household type is concerned, it is interesting to note that the estimated rental savings of tenants with children is less than the savings of non-elderly childless individuals and couples. Clearly, the program is not one targeted at families with children.

Security of Tenure (Chapter 8)

The right to continued occupancy of a rental unit is of great importance to tenants. Not only can moving be costly and disruptive, but individuals often attach a considerable value to retaining their own home, whether that home be rental or ownership. Rent review is often seen as essential to the preservation of security of tenure in that a high rent increase can drive a tenant out as surely as a notice of eviction. Indeed, the term "economic eviction" can be applied to such cases.

The provision of security of tenure is quite recent in Ontario. Prior to 1970, tenants had no security of tenure beyond that specified in their lease agreement. In 1970, the first reforms were implemented which required landlords to obtain a writ of possession from the county or district court in order to evict. The court could refuse an eviction

where the landlord was in breach of his obligations or in cases where tenants were attempting to enforce their legal rights. In 1975, coincident with the introduction of rent review, a major additional step was taken towards full security of tenure, whereby landlords could only obtain an eviction for causes specified by legislation.

Every increase in security of tenure, or in other restrictions, constitutes a reduction in the effective property rights of landlords. The Landlord and Tenant Act restricts eviction and termination. The Residential Tenancies Act restricts rents and reductions in maintenance. Land use policies of municipalities can restrict conversion of rental units to condominium use. Pressure also exists for extension of restrictions to exclude adult only buildings and to limit demolition of rental buildings. Taken together, such restrictions would limit all the major decisions that landlords could formerly make on the use of their property. Accordingly, such restrictions limit the attractiveness of rental development.

To a considerable extent, landlords have come to accept the restrictions related to security of tenure. They have a great concern, however, with the delays involved in current procedures. The Residential Tenancies Act would have expedited these procedures by taking the process out of the court system and placing it with the Residential Tenancy Commission. This change would also have applied to items of significant importance to tenants. The Supreme Court of Canada, however, ruled these Sections of the Act beyond provincial jurisdiction.

Related to security of tenure is the concept of security of choice. Low vacancy rate conditions may limit the degree to which tenants may move in response to either changing need or to avoid deteriorating conditions. To the extent that low vacancy rates are associated with rent review and the administration of security of tenure, these will be in conflict with the desire for security of choice.

Finally, there is the issue of how security of tenure could be guaranteed in absence of rent review. To deal with the problems faced by these tenants, consideration could be given to restricting unconscionable increases beyond market levels. This would serve to eliminate economic evictions.

Values and Perceptions (Chapter 9)

The empirical analysis in the report does not cover the full range of issues related to rent review. In addition, there is also a strong social value component to the debate. As well, the concerns addressed by rent review must be seen in the context of the attitudes formed in the current inflationary environment.

There are three sets of social values that can be distinguished in the discussion of rent review. They may be termed the "free market," the "cost only" and the "adjustment and protection" approaches.

The free market approach is characterized by its emphasis on individual freedom in making decisions. Most economic transactions are, in this view, to the mutual benefit of both parties. The competition among thousands of landlords is seen as the mechanism whereby increased profits of landlords are translated into the additional supply required to meet demand conditions. The ability of prices to adjust to changed economic circumstances is judged appropriate not only for its own sake, as an expression of economic freedom, but also because of its contribution to total welfare in meeting the needs of others.

At the core of the cost only approach is a view that profit levels should be reduced. The extreme view would eliminate profits altogether. In essence, this view holds that rental housing should be regarded as a public utility. In more moderate form, profits are to be frozen in dollar amount, with inflation allowed to eat away at the value over time. Thus, unlike wages, the incomes of landlords would not to be allowed to adjust with inflationary conditions.

A number of beliefs can be at the basis of the cost only view. One is that profits are never justified. A second is that competition does not exist. A third is that demand conditions should not be allowed to influence prices. A fourth view is that changes in rents to reflect changed economic circumstances are not warranted either because it is believed that circumstances have not fundamentally changed or because it is believed that renters should be protected indefinitely from such changes. Each of these views rejects the role of market prices in the economic adjustment process.

The adjustment and protection approach accepts that higher costs including interest rates and greater demands for rental units indicate a need for adjustment in the price of rental units. This view, however, notes that housing markets can adjust only slowly to changed conditions given that new production is low relative to the entire stock. Thus, while accepting the need for current controls, it also accepts the need for longer term adjustment to free market values. Hence, controls are to be structured with the objective of phasing in the longer term market balance.

Recent inflationary conditions have served to disorient many people in making economic judgements. A wage earner may be concerned about a 6 per cent rent increase despite the fact that his wage may have risen by 12 per cent. Others look to the guideline as a means of increasing certainty or as a means of making up for a failure of income to increase. Finally, one may look to rent review as a component in an anti-inflationary policy.

On the other side, one should look at a landlord view. Controls at 6 per cent are lowering the rent to income ratio of his wage earning tenants, while his profit levels are frozen or declining in real terms. Any increase in certainty of rent increases for the tenant, means that landlords' profits bear the risks of higher inflation. Also, while rent saving lowers inflation for tenants, it does not for landlords.

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